Defeating Short-Termism: Why Pension Funds Must Lead

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Among the lessons from the recent market crisis is the interconnected nature of the challenges we face, and that we can no longer afford myopic responses. This reality has material implications for pension fund trustees and managers. The time has come for them to lead rather than be dragged along. This article proposes a number of steps that can be taken to better align incentives and frame decision-making for longer-term perspectives.

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"There is no quality in human nature, which causes more fatal errors in our conduct, than that which leads us to prefer whatever is present to the distant and remote."

David Hume, A Treatise on Human Nature (1739-1740)

Complexity and Leadership

If one thing is clear from the current market crisis, it is that we all face increasingly complex decisions about issues in which we are flooded with information but know very little about. It is striking how often the crisis we end up struggling with is not one most were anticipating. If we use the recent failures in financial markets as an example, many express concerns about conflicts of interest (which, once clearly identified we can try to manage) and complacency (which may be endemic to human nature), however, it is complexity and connectedness that now pose the greatest challenges for those seeking to reshape governance processes. Risk management methods and models are being reconceived to address these issues, similar to what has already occurred in sectors such as human trial pharmaceutical testing or nuclear energy. The same can be said for how we think about many other public policy concerns.

The costs of the current financial crisis – both immediate and in terms of intergenerational transfers / subsidies – have dramatically accelerated the opportunity and need for being ahead of our time. However, the contours of more inclusive governance architecture to address the challenges of connectedness are not yet clear. We should be mindful of Milton Friedman's 2002 admonition to his fellow monetarists while they were out of favor:

"This, I believe, is our basic function: to develop alternatives to existing policies, to keep them alive and available until the politically impossible becomes the politically inevitable."

Issues that were once a matter of academic discourse have indeed taken on a sense of urgency. In spite of this, it is evident that leaders need to be careful not to promise quick solutions.

Instead, leaders need to look further ahead – well beyond patching things up enough to get incumbent governments through the next election or managements through the next quarterly reporting cycle. Assumptions have changed radically. Instead of continuous growth, leaders now face decisions predicated on the allocation of scarce (economic or ecological) resources. Accordingly, they require both vision and patience to foster common understanding of problems and long-term, sustainable solutions.

In doing so, our leaders must look beyond the regulation of discrete markets and be prepared to deal with broader policy concerns relating to economic and other imbalances. If not, such issues may well spur a stampede away from the global cooperation required to meaningfully address incentives and mechanisms to reduce systemic risks. For example, a recent report[1] from the United States National Intelligence Council (NIC) vividly highlights the risks of climate change impacting on resource scarcities and the consequential (frightening and

perverse) economic and political actions in anticipation and response.[2] Leaders also have to widen the circle beyond what have traditionally been thought of as the dominant global powers, recognizing that political solutions depend on the conditions each government faces at home while governance solutions require a platform for building consensus that stretches across sectors and beyond political or geographic boundaries.

What better place to start this call for new leadership than with the pension fund community which manages long-term, locked-in savings on behalf of others? As the demographics of our aging population and the full scope of current losses (including savings, employment, public confidence, and fiscal prudence) becomes apparent, what better way to reconnect citizens with the organizations in which they invest and work?

Time for Pension Trustees and Managers to Step Up

The opportunity for trustees and fund managers to have an impact is high; so, too, is the opportunity cost of defaulting on this opportunity. American institutional investor ownership of Fortune 1000 companies has increased to seventy-six percent of outstanding equity.[3] In several countries, the aggregate value of pension fund assets exceeds Gross Domestic Product (GDP).[4] Overall, the average pension assets-to-GDP ratio for Organisation for Economic Co-operation and Development (OECD) countries in 2007 was seventy-six percent.[5] By choice, by chance, or by default, the scale of such investment pools will attract scrutiny and high public expectations.

Historically, the buy-side (those who manage savings for others) depended on the sell-side (market intermediaries and other service providers). The nature of this strong and often debilitating dependency was illustrated in a recent survey by Rhjan (2008) of European fund managers, which noted that:

"There's a widespread perception in the pension world that the investment industry is perverse in one crucial sense: its food chain operates in reverse, with service providers at the top and clients at the bottom. Agents fare better than principals."

Curiously, when it comes to regulation, the sell-side has traditionally attracted more attention. This has been an implicit rationale for buy-side passivity; laying low to avoid public scrutiny. The focus, however, is properly shifting to the competencies and responsibilities of institutional investors, who willingly purchased many of the financial products that went sour.

Did these institutions rely too heavily on ratings, taking them as a proxy for market value without considering whether the instruments were suited to the portfolios they managed? Are trustees and fund managers fulfilling the roles assigned to them by corporate and fiduciary laws? For equities, to what extent did the performance culture on the buy-side fuel leverage and shorten hold periods? What is the impact of genuine concerns about the management and governance of portfolio companies when trustees and fund managers do not have a long-term vested ownership interest? It is difficult to fault the short-termism of corporate Chief Executive Officers and directors to the extent such behavior reflects and is responsive to myopic investor preferences.[6]

The time has come for trustees and investment managers to assume a broader and more active leadership role in financial markets and beyond. Why? Because their failure to look ahead and outward, given the increasingly obvious impacts on investments over the long term, may well constitute a failure of duties owed to those who entrust their savings with them. The British Trade Union Congress (2009) focused on an element of this concern in a recent statement on the responsibilities of major shareholders, recommending that pension funds insert a "do no harm" clause into statements of investment principles, requiring fund managers / advisors to satisfy trustees "that their investment decisions are not causing systemic harm to the stability of the financial system and therefore to the long-term interests of their beneficiaries."

To tweak the old aphorism, people who live in glass houses should always answer the doorbell. In the face of current market failures the temptation is to look for scapegoats and call for more accountability elsewhere, but trustees and investment managers responsible for long-term savings are uniquely suited – if not obliged – to lead by example with respect to effective governance. It is up to them to aggressively advance the process of developing models that are not solely about rules and reporting or compliance, but rather, involve thinking more deeply about what motivates good behavior and informed judgment. They should be doing so for themselves and for the enterprises they invest in. This requires a long-term view that brings coherence to a range of disparate systemic risks. The effects could be powerful and stimulate a much broader awareness-tipping process by setting an example and expectations for corporate and political leaders to follow.

From Saying to Doing: Some Modest Steps

A useful starting point is reconsidering the standards to which trustees and investment managers, and in turn, corporate boards, are held accountable. Today's standards focus on acting with the care, skill, and diligence that a prudent person would exercise in similar circumstances in the interests of beneficiaries or the corporation. A number of concerns have become apparent with such a standard. For starters, trustees are also subject, and should be held accountable, to a duty of impartiality, which requires them to "identify, respect and balance the various … interests"[7]

of different participant and beneficiary groups. Arguably, directors should be held accountable to a similar standard. Such a focus on long-term wealth creation requires consideration of a wide range of governance, systemic, and intangible factors that extend beyond short-term financial or other performance metrics.

Existing standards leave unanswered how to address conflicting interests of different beneficiary groups or corporate stakeholders and lead to herding behavior, magnifying risk by mitigating systemic diversification. The most obvious example was the unrelenting focus of investment (and corporate) managers on short-term performance, with commensurate inattention to sustainability concerns. As recently noted by two leading business organizations (CFA, 2006):

"The obsession with short-term results by investors, asset management firms and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance."

Part of the difficulty has been the anemic nature of standards that evolved through the interaction of corporate statutes and jurisprudence. The subjective nature of the duty of care or prudence tends to reinforce herd-like and generally short-term behavior.

John C. Bogle (2009) referred to the challenge of establishing a "fiduciary society" based on statutory duties to focus on long-term investment, appropriate due diligence and "ensuring that managers / agents act in a way that reflects their ethical obligations to society."[8] Given the nature of their responsibilities, trustees might also be subjected to specified skill levels, both in respect of investment theory and practice, as well as governance dynamics. These ideas are explored in considerable detail by Keith Johnson and Frank Jan de Graaf (2009) in a recent article in the *Rotman International Journal of Pension Management*.

Trustees and fund managers should also be held accountable for proactively taking steps to better align interests between owners and their service providers. Cass Sunstein and Richard Thaler address some such measures in *Nudge* (2008), their recent book on "choice architecture." Similarly, the Network for Sustainable Financial Markets (NSFM) recently posted several papers on issues such as the production and sale of investment research,[9] or the need for the development of fee structures that are aligned with the value delivered.[10] A good first step would be to identify misaligned interests throughout the service provider chain with a view to better managing them.

As is so often the case, recent regulatory initiatives in this area have done little to cure the underlying problems, and the few that have been implemented have had unintended consequences.[11]

NSFM suggests that requirements should include full and standardized disclosure by the buy-side to its clients of financial relationships with the sell-side. Put simply, the end-user should know how their money is spent. One recommendation is to mandate that buy-side firms report to their clients the full details of business arrangements (and potential conflicts of interest) with sell-side firms. Another NSFM proposal is compulsory publication by sell-side institutions of current and past recommendation balance (and past track record) in respect of all issuers they cover and, in particular, a comparison to those in respect of their corporate clients. This would expose conflicts and provide useful benchmarks; the financial equivalent of disclosing baseball players' batting averages. Ideally, the industry would develop and embrace a uniform reporting framework, rather than have it imposed by regulators.

NSFM would also follow-up on former Securities and Exchange Commission (SEC) Chairman Christopher Cox's commitment to tackling the problem of companies freezing out analysts who write negatively about them.[12] NSFM proposes that regulators impose on research firms, as a licensing condition, the obligation to publicly report such incidents.

Historically, innovation in capital markets, and in particular securitization, has yielded significant benefits: reducing transaction and monitoring costs, increasing liquidity, and enhancing investor returns. Looking ahead, its utility as a policy instrument for the allocation of scarce resources (e.g., energy, air, water) should not be discounted.[13] However, securitization has also had profoundly negative impacts on the incentives that motivate and discipline financial intermediaries, investors, and corporate managers – and as a result, on the real economy. At its simplest level, it has attenuated the focus of market actors on the notion of responsibility that we traditionally associate with ownership.[14] This poses challenges for corporate governance and the allocational efficiency of capital markets. To the extent it has made the goal of financial stability increasingly elusive, a useful focus might be on measures designed to restore transparency, improve internal risk management, and mitigate asymmetries of risk and reward in order to insulate underlying economic activity from the most pernicious consequences of perverse incentives and resultant volatility.

Here again pension fund managers should be leading by example, starting with the very types of compensation tools they are now advocating for the corporate sector. Three stand out in terms of effectively realigning focus:

1. Hold through retirement or other long-term approaches for variable compensation policies (such as ExxonMobil, in which a substantial portion of performance-related compensation does not vest until retirement or ten years from the grant, whichever comes later).[15]
2. Clawback provisions (triggered, for example, by any material restatement).

3. Enhanced disclosure focusing on the average holding period of compensation.[16]

Corporate boards need to reexamine their role too. In its recent BCE decision, the Supreme Court of Canada suggested that a board's duty is to act in the best interests of the corporation, "viewed as a good corporate citizen" and consider "short and long-term interests".[17] Others have anticipated such admonitions, suggesting that fiduciaries, in discharging their duty of care, should consider potential impacts on various stakeholders.[18] This comports with a more general understanding that taking a broader view will lead to better decision making.[19]

An additional public policy challenge is to implement low cost, universal, default retirement savings schemes such as those outlined by Keith Ambachtsheer in his 2008 C.D. Howe Institute Commentary. Precedents abound.[20]

The View from the Proverbial Fork in the Road

Sustainable economic recovery depends on restoring public trust and confidence in a willingness to work together, to think ahead, and to think long-term. The challenge is the same for political, corporate, and investment management leadership. It may, however, be simplest and most effective for pension fund trustees and managers to step up first. They are specifically charged with taking a long-term view and should be held accountable for doing so. They must articulate the kind of governance, people, and process changes needed to reestablish the central role of capital markets in our society. If we can calibrate standards to better inform and motivate their conduct, the models may serve us well in a broader context. If not, we are likely to continue to get the fare we deserve.

Endnotes

1. The report, *Global Trends 2025: A Transformed World*, is available at http://www.dni.gov/reports/2025_Global_Trends_Final_Report.pdf.
2. See Klare (2009), which predicts increased civil unrest and other strife as people lose confidence in the ability of markets and governments to solve the global crisis.
3. See Brancato and Rabimov (2008).
4. At the end of 2007, this was the case in Iceland, the Netherlands, Switzerland, and Australia.
5. OECD (2008).
6. See Samuelson and Stout (2009).
7. American Law Institute (2003).
8. Also part of a longer piece by John C. Bogle titled "Building a Fiduciary Society" (The Corporate Board, July/August 2009).
9. See Michael Mainelli, Jamie Stevenson, and Raj Thamotheram's paper, "Sell-Side Research: 3 Modest Reform Proposals," available at www.sustainablefinancialmarkets.net (January 19, 2009). See also Jamie Stevenson's article, "A modest proposal for better research" (*Financial Times*, March 15, 2009).
10. See Keith L. Johnson and Frank Jan de Graaf's "Modernizing Pension Fund Legal Standards for the Twenty-First Century," available at www.sustainable financialmarkets.net (February 11, 2009). DOI: 10.3138/rijpm.2.1.44
11. See Ohad Kadan, Leonardo Madureira, Rong Wang and Tzachi Zach's "Conflicts of Interest and Stock Recommendations: The Effects of the Global Settlement and Related Regulations" (February 2009), available online at http://ssrn.com/abstract=568884. In response to recent regulation of sell-side research the authors find that the overall informativeness of research recommendations has declined. The bulk of the A$460 million that funded alternative research under the terms of the 2003 regulatory settlement will lapse in the new few months raising questions about both the impact of such research and the termination of funding obligations. See also "Settlement's End Puts Research Up in the Air" by Lynn Cowan and Ed Welsch (*Wall Street Journal*, May 13, 2009) and "Research Conflicts Point Way for Ratings Agencies" by Sallie Krawcheck (*Financial Times*, July 21, 2009).
12. See Mary Lowengard's article, "Guide to Icing Analysts," *IR Magazine*, January 2006, page 26.
13. Securitization presents an opportunity to create property rights through market-based solutions (i.e., price discovery) with respect to public policy concerns as diverse as pollution, pandemics, species management, or medical issues.
14. The Turner Review (FSA, 2009) in the United Kingdom noted that much of recent securitization activity did not enhance the efficiency of credit intermediation; rather, it facilitated economic rent extraction by the asymmetry of knowledge, market opacity and inherent conflicts of interests between principals and agents.
15. For example, see Sanjai Bhagat and Roberta Romano's article "Reforming Executive Compensation: Focusing and Committing to the Long-Term," (February 2009, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1336978) and Richard A. Posner's article "Are American CEOs Overpaid and, If So, What if Anything Should be Done About It?," (Durham: Duke Law Journal, March 1, 2009).
16. While public companies routinely state that their executive compensation schemes are intended to focus managerial attention on long-term shareholder value, existing proxy disclosures do not facilitate the evaluation of such claims. Moreover, while compensation disclosure requirements have ratcheted up compensation levels, it is hard to imagine that term-related disclosure requirements would have that effect.
17. BCE Inc. v. 1976 Debentureholders (2008) S.C.J. No. 37, SCC 69. Regrettably, in the absence of clarity with respect to purpose and responsibilities (which the Court did not provide), such phrases could lead to a diminution in accountability. Something for everyone may mean too little for anyone.
18. See Judd F. Sneirson, "Doing Well By Doing Good: Leveraging Due Care for Better More Socially Responsible Corporate Decision-Making", Volume 3 The Corp. Gov. Law Review 438 (2007). For an excellent discussion of legal practical aspects of integrating environmental, social, and governance issues into institutional investment see "Fiduciary Responsibility," a July 2009 report by The Asset Management Working Group of the United Nations Environment Programme Finance Initiative. Available at http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf.
19. See e.g., Michal C. Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function", Volume 14 Journal of Applied Corporate Finance 8 (2001). doi:10.1111/j.1745-6622.2001.tb00434.x.
20. The Chilean and recent British experiences are instructive, as are plans such as TIAA-CREF in the United States or Saskatchewan's Cooperative Superannuation Society Pension Plan (CSSPP).

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